No. 9909

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JACK L. WARNER,
Respondent.

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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Preliminary Statement

This is a petition by the Commissioner of Internal Revenue to review a decision of the Board of Tax Appeals entered in favor of the respondent on December 13, 1940 (R. 120). The appeal involves gift taxes alleged to be due from the respondent for the calendar years 1932, 1933 and 1935. The opinion of the United States Board of Tax Appeals is reported at 42 B.T.A. 954, and is to be found at pages 112 to 119 of the Record in this appeal.

The Supreme Court of the United States having rendered its opinion in *Ryerson* v. *U. S.,* 312 U. S. 405, the respondent herein admits that assignment of error No. 6 (R. 125), is correct and that the decision of the Board of Tax Appeals should be modified accordingly. This eliminates further consideration of Question numbered 2 (petitioner's brief, pp. 2, 7).

Statement of Facts

The opinion of the Board of Tax Appeals adopted the facts as stipulated (R. 113). They may be summarized as follows:

The three Warner brothers, Harry, Albert and Jack L. Warner, were at all times and still are the principal executive officers of Warners Bros. Pictures, Inc., a Delaware corporation, which in 1923, acquired the assets of a partnership then composed of the aforesaid three brothers and a fourth brother, Samuel L. Warner, since deceased. The partnership was engaged in the business of producing and distributing silent motion pictures and the corporation continued the business of the partnership, and since 1926 has been a producer, distributor and exhibitor of talking motion pictures. Until the time of his death in October, 1927, Samuel L. Warner, the deceased brother, was one of the principal executives of the corporation, as was Lewis J. Warner, the son of Harry M. Warner, up until the time of his premature death in April, 1931 (R. 37).

The motion picture business engaged in by Warner Brothers, the partnership, and by the corporation, Warner Bros. Pictures, Inc., was speculative and fluctuating (R. 39). With the advent of "sound", the busi-

ness of the corporation rapidly expanded, but continued to be hazardous and volatile. The stock of Warner Bros. Pictures, Inc. fluctuated violently on the New York Stock Exchange. From January 1926 through September 1926 the market quotations rose from $15 to $70 a share. From May 1927 to April 1928 the price had receded to as low as $30 a share. But in September and October 1928 the stock advanced to as high as $138 a share, but receded in March 1929 to $100 a share. Thereafter it was split two for one and in November 1929 sold at $30 per share (new stock), a decline of 40 points from the previous March. But in March, April and May 1930, the new stock sold at $80 a share or an equivalent of $160 for each share of the old stock. In June 1930 the price declined again to $45 a share; in August 1930 to $25 a share and in June 1931 to $5 a share and finally in May 1932 to 75 cents a share (R. 38). The date of the Trust Indenture involved is May 26, 1932.

In 1928 and 1929, each of the three Warner brothers was the owner of a substantial fortune invested almost entirely in Warner Bros. Pictures, Inc. securities. The corporation in which their fortunes were so invested had been in frequent need of financing, and particularly in its process of expansion, became at times heavily indebted to banks and bankers for borrowed money. Believing that they would obtain greater protection for their investments in the company and assure the company a stronger financial position, the Warners determined to liquidate a part of their holdings in securities of the company, so as to make cash available which they could loan to it as and when needed. This, they proceeded to do, with resulting accumulation of large cash reserves

which from time to time, through the medium of Renraw Inc., a corporation owned by them, were loaned to the Warner Corporation, at one time indebted to them for cash loans of between five and six million dollars (R. 38).

Renraw, Inc., incorporated under the laws of the State of New York in 1925, had an original capital of 500 shares equally divided among the Warner brothers. On July 27th, 1929, in connection with an increase in the capital of Renraw, Inc., 60,000 shares of new preferred stock were issued in equal amounts to the three brothers, in consideration of the payment by them of $6,000,000 in cash, obtained by them through the sale of Warner Bros. Pictures Inc. stock as aforesaid (R. 39).

Increasing profit in the operation of its business during the years 1929 and 1930, made it possible for Warner Bros. Pictures, Inc., to repay to Renraw, Inc. substantial amounts of the foregoing loans and the balance thereof was liquidated when the corporation secured funds by new financing in September, 1930 (R. 39).

At this point the Warner brothers, realizing that they were in a position to segregate a part of their resources and remove the same from existing hazards of the motion picture business, began in March, 1930, through Renraw, Inc., to purchase United States Government obligations, which they did to the extent of $5,600,000 of such obligations (R. 39-41). This completed the *first step* in their projected plan of economic security for themselves, their wives and their children.

While the business was building up and the Warner resources were increasing, Lewis J. Warner, the only son of Harry M. Warner, oldest of the Warner brothers, and who was himself an employee and officer of Warner Bros. Pictures, Inc., was regarded by his father and uncles as

the ultimate representative of the interests of the Warner family in the corporation of Warner Bros. Pictures, Inc. (R. 37). The death of Lewis Warner on April 4, 1931 was a great shock to his father and had an important effect upon the plans of the father and uncles in the arrangement of their personal fortunes. They could no longer look to Lewis as the one who might be expected to take care of the wives and children of the Warner family and to be the ultimate representative of the family interests. Accordingly, the Warner brothers after discussions among themselves and with their financial advisors concerning the best means to be employed to insure the financial security of themselves and their families and to protect that security against all exigencies decided to establish trust funds (R. 40, 41).

Each brother determined to transfer his $2,000,000 of Government securities to a trust in such form that the corpus would be secured from the hazards of business, secured against any actions by the brothers individually or collectively or by the members of their immediate families, secured for the protection of the wives and children of the three Warners (R. 42). This completed the *second step* in their projected plan for security.

The decision to establish trust funds having been made, the capital of Renraw, Inc., was reduced and each of the Warner brothers surrendered to Renraw, Inc., the 20,000 shares of preferred stock owned by him and received an equal one-third of $5,600,000 face amount of Government obligations, and other assets to the amount of $400,000. The $400,000 was used to purchase additional United States Government obligations so that each brother became, in December 1931, the owner of $2,000,000 principal amount of U. S. Government obligations (R. 41, 42).

Having decided that the general objectives referred to above could be accomplished by the establishment of trust funds, the Warners consulted their counsel, Stanleigh P. Friedman, explained to him the objectives desired, and arranged for the representatives of Central Hanover Bank and Trust Company of New York City to co-operate with him in the preparation of definitive papers (R. 42). Mr. Friedman has been the advisor and counsel of the Warner brothers personally, and of the corporations in which they have been interested, and of members of the Warner families from 1912 to the present time. He has at all times enjoyed the confidence and affection of all members of the Warner families. To provide that in the event of the death of one of the brothers, his widow and children would not be subjected to the influence of the remaining two brothers, alone, because each brother had his own idea of policy and was not willing to subject his estate to different philosophies of investment of the surviving brothers alone, Mr. Friedman was integrated into each of the trusts as a permanent trustee and as one of those having joint power to amend or revoke (R. 43, 44). Neither Mr. Friedman nor the legal representatives of Central Hanover were consulted until after the Warner brothers had decided on the establishment of trusts to achieve the general objectives hereinbefore set forth. In the course of discussions which followed, counsel advised that the trusts be drawn in the form in which they were finally executed in order to carry out their intentions to:

(a) secure a "maximum of irrevocability"* by the grantor;

(b) make it impossible for any one of the brothers to "invade the corpus";

(c) exclude any "possibility of reverter" of the corpus of any trust;

(d) eliminate the grantor of each trust from becoming a possible income beneficiary;

(e) provide that in the event of the death of any brother his widow and children would not be subject to the influence and divergent investment policies of the remaining brothers alone;

(f) minimize and avoid estate taxes which counsel believed might be due under some different form of trust procedure than that which was adopted (R. 43, 44).

Therefore, and as the *final step* in their plans, on or about May 26th, 1932, Albert Warner, a brother of the respondent herein, executed an Indenture of Trust, bearing said date, of which a copy, as executed, is attached to the Stipulation of Facts as Exhibit A (R. 51-80). On or before June 4th, 1932, Albert Warner delivered said Indenture to the trustees named therein and delivered to Central Hanover, one of the trustees, on behalf of all of them, $2,000,000 principal amount of United States Government obligations, which belonged to him and for which a receipt was executed and delivered to him by Central Hanover describing said securities by number and amount (R. 32).

* Misquoted as "maximum of revocability" in the Opinion of the Board of Tax Appeals and in the Brief for Petitioner. (See Stipulation, par 18, R. 43.)

The income received by the trust executed by Albert Warner was entirely paid out to the beneficiaries and treated by them for Federal income tax purposes as taxable income for the years and in the amounts following:

	Jack L. Warner	Irma Warner	Jack M. Warner
1932........	$20,009.16	$10,004.52	$10,004.52
1933........	35,542.25	17,774.49	17,774.49
1934........	42,391.13	21,581.76	21,195.58
1935........	37,174.97	16,678.18	18,581.60

(R. 35, 36)

Petitioner contends that the foregoing payments to Irma and Jack M. Warner were gifts to them by respondent.

Since the petitioner in his Statement of Facts has considered it convenient for comparison to tabulate significant provisions of the Albert Warner Trust and two other trusts created by his brothers (petitioner's brief, p. 4), we are constrained to point out his failure to include as one of the trustees in each trust, the person called by him the "nominal grantor". The petitioner's tabulation also contains the additional error that Harry M. Warner is named as a beneficiary of the trust in which the "taxpayer" is referred to as the "nominal grantor". To correct these errors and to prevent the confusion which might result from petitioner's self-serving reference to Jack as the "taxpayer", we submit the following accurate tabulation.

Grantor	Albert Warner	Jack L. Warner	Harry M. Warner
1. Beneficiaries	Jack L. Warner Irma Warner (divorced wife of Jack L.) Jack M. Warner (then a minor)	Rea Warner Betty Warner (Sperling) (then a minor) Doris Warner LeRoy (then a minor—wife and daughters of Harry M. Warner)	Albert Warner Bessie Warner
2. Trustees	Albert Warner Harry M. Warner Jack L. Warner Stanleigh P. Friedman Central Hanover Bank	Albert Warner Harry M. Warner Jack L. Warner Stanleigh P. Friedman Central Hanover Bank	Albert Warner Harry M. Warner, Jack L. Warner Stanleigh P. Friedman Central Hanover Bank
3. Persons having the joint power to amend and revoke	Jack L. Warner Harry M. Warner Stanleigh P. Friedman	Albert Warner Harry M. Warner Stanleigh P. Friedman	Albert Warner Jack L. Warner Stanleigh P. Friedman
4. Recipient of corpus in event of revocation	Jack L. Warner, if alive—if not alive, then his estate	Harry M. Warner, if alive—if not alive, then his estate	Albert Warner, if alive—if not alive, then his estate

The trustees of the respective trusts duly qualified and entered upon the performance of their duties as trustees under said Indentures, collected the income aris-

ing out of the securities constituting the trust corpora and paid the entire amount thereof, less commissions, to the respective beneficiaries named in said Indenture in accordance with the terms thereof (R. 33).

Questions Presented

The question in the case as presented by the petitioner (his brief p. 1) is predicated upon assumptions of fact so prejudicial to open-minded consideration of the case, that we take exception thereto. The petitioner avoids the force of the facts as stipulated and *creates* a structure upon which he expounds the law which would be applicable if the facts were assumed by him.

The primary issue in this case is (1) whether Albert Warner is the real grantor and settlor of a trust created by him consisting of securities owned by him and delivered to trustees named in a Trust Indenture executed and delivered by him in which he does not reserve the power to revoke, alter or amend the trust, either in himself alone or in conjunction with any person, or whether by virtue of a legal fiction Jack L. Warner, one of the beneficiaries may be treated as real grantor; and, (2) if the latter, whether such substituted grantor has such exclusive, absolute and unconditional power of recall and revocation, or dominion and control over the trust (ignoring adverse interests) that the payments of income from said trust by the trustees to the beneficiaries other than Jack L. Warner, constitute gifts by Jack subject to Gift Tax Law. Moreover, the trust was created on May 26th, 1932, before the incidence of the Gift Tax Law.

If petitioner fails to substantiate the fictitious situation which he has sought to create by the substitution of Jack as the grantor of the trust created by Albert, this being his major premise and the *sine-qua-non* of his success in this appeal,—his entire case falls.

On the other hand, if peradventure, the petitioner should prevail on the main issue that Jack L. Warner is in theory of law the grantor of Albert's trust, the petitioner must nevertheless establish—and the burden is upon him to do so—that the trust is of such a character as to make the income payments to the beneficiaries, transfers by Jack subject to Gift Tax.

POINT I

Albert Warner is the grantor and settlor of the trust created under Indenture of Trust executed by him, and he was the owner of the securities which he delivered to the trustees as the corpus of said trust. There is no justification for the assertion by the Commissioner that Jack L. Warner is the settlor.

The contention of the petitioner (pages 8 and 11 of his brief), is that "under the circumstances of this case" Jack L. Warner is "the real grantor" of the trust created by Albert Warner; that because *he,* Jack L. Warner, has "*retained* the power to revoke" (which, of course, he could not have *retained* unless it be admitted that he was the grantor) along with two other persons *having no adverse interest* (contrary to fact), he is subject to gift tax with respect to the income paid by the trustees to his divorced wife Irma and son, Jack M. Warner. To justify this argument he departs from the record, and extracts

from the Stipulation of Facts the fiction that Jack and not Albert is the real grantor of the trust. Proceeding upon this fictitious transposition of grantors,—indispensable to his entire case,—he indulges in an exposition of the legal consequences which would follow if Jack were the creator and grantor of the trust in question.

The facts as stipulated disprove the petitioner's allegations and reject his unwarranted conclusions.

The Trust Indenture under review sets up trust funds (a) for the benefit of Irma S. Warner, for life, with remainder over; (b) for the benefit of Jack M. Warner, son of Jack L. Warner, for life, with remainder over, and (c) for the benefit of Jack L. Warner for life, with remainder over.

The trustees are the grantor (Albert Warner), his two brothers, Harry M. and Jack L., Stanleigh P. Friedman and Central Hanover Bank and Trust Company. Their powers are narrowly limited. With respect to investments—paragraph 3 of the Indenture provides, that the trustees may continue to hold in the trust all property conveyed thereto, but in the event of a sale of all or any part thereof, the reinvestment of the proceeds is limited to United States obligations, to obligations of any State and to the obligations of a county or city only of the States of New York, New Jersey, Massachusetts, Pennsylvania, Ohio, Illinois, Maine, Rhode Island, Maryland and California. The power of sale, itself, may only be exercised upon direction of the three Warners acting *"jointly and unanimously"*, so long as the three are living. It should be noted that upon the death of any one of the Warner brothers, Stanleigh P. Friedman automatically succeeds to the powers of the decedent, as representative of the beneficiaries. The exercise by the

trustees of any right of conversion or subscription or participation in a reorganization, consolidation, etc., requires similar joint and unanimous action. There is a marked absence of broad powers of investment and management in the trustees.

When Albert Warner, on June 4th, 1932, delivered $2,000,000 of his securities to Central Hanover, he completely divested himself of all ownership, enjoyment, domination and control thereof. In the Trust Indenture executed and delivered simultaneously therewith, he reserved no power in himself alone or in conjunction with any person to alter, amend or revoke the trust.

The trustees who accepted the trust became legally bound to administer the trust in accordance with the terms and obligations of the Trust Indenture. This included a paramount duty on all of the trustees, including Albert Warner as a trustee of this particular trust, to see that the objectives of the trust were preserved regardless of whether he be considered grantor or "revocator." Albert, as trustee, holds a position of substance and has a vital obligation to protect the interest of his *cestuis*. (Cf. tabulation page 9.) All payments of income thereunder to the beneficiaries were in pursuance of legal obligations assumed by the trustees on June 4th, 1932. The beneficiaries were at all times thereafter in a position to insist upon fulfilment of those obligations by payment to them of the income to which they were entitled by virtue of a completed gift then made. (Cf. *Mead* v. *Commissioner,* 41 B.T.A. 424.)

There is a power of revocation set forth in the Indenture but it is vested not in the grantor, but in Harry M.

Warner, Stanleigh P. Friedman and Jack L. Warner and their survivors acting jointly and unanimously (Indenture, Paragraphs 5 and 11, R. 73, 79). Paragraph 5 of the Indenture among other things, states—

> "In case this Indenture and the trusts hereby created shall be revoked in whole or in part, the property constituting the trust estate or so much thereof as to which the trust is revoked shall be transferred, assigned and delivered by the Trustees to Jack L. Warner or to the estate of Jack L. Warner, if he be deceased."

In the event that a dispositive provision in favor of any beneficiary is revoked, that part as to which it may be revoked, by the very act of revocation, would pass to Jack L. Warner or his estate, freed from the trust.

There is no "possibility of reverter" in the grantor.

The grantor Albert Warner was advised by counsel to avoid the reservation, however remote, of any interest in the trust res, lest that remote interest, bring the trust res within the reckoning of his taxable estate upon death (R. 43). Albert accepted the advice of counsel to execute an Indenture which had been drawn deliberately with the foregoing purpose.

Harry M. Warner and Stanleigh P. Friedman are persons having substantial adverse interests.

The petitioner recognized however, that he could not rest his case solely upon the hypothesis that Jack L. Warner was the settlor of the trust and so proceeded with a further arbitrary assertion, indispensable to his theory, viz.: that Harry M. Warner and Stanleigh P. Friedman are persons having no substantial adverse interest in the disposition of the trust property or the in-

come therefrom. The evidence is to the contrary. The question of adverse interest is fully discussed in Point II (*infra,* p. 20 *et seq.*).

Substitution of Jack for Albert as grantor compels elimination of Jack as a "revocator".

Certain dominant purposes and reasons dictated the limitations imposed by the Trust Indenture upon each of the persons or groups of persons who were to assume the responsibilities assigned to them by that instrument. One of the most important restrictions carried out the intention that the grantor of the trust was not and could not be a "revocator". When the Commissioner finds it in the interest of the Revenue to indulge in the transposition of grantors (Jack for Albert) he does violence to both the intention and the action of the parties affected by the Indenture. The motive for his doing so is that, by substituting Jack for Albert as the grantor, he gains a grantor who is also a "revocator" and, in the absence of adverse interests, the statute would operate without help to give the Commissioner the result that he wishes.

It would be easier to condone the substitution of Jack for Albert as a grantor if the Commissioner carried his transposition to its logical conclusion and substituted Albert for Jack as a "revocator". We may only conclude that he stops short in the logical process because he realizes that the substitution of Albert for Jack as a "revocator" would defeat his purpose, although the intention to maintain irrevocability by the grantor would be respected by so doing.

Petitioner's contention for substitution of grantors is grounded upon the case of *Allen S. Lehman,* 39 B.T.A. 17, affirmed (C.C.A. 2, 1940), 109 F. (2d) 99.

In that case the decedent Harold Lehman and his brother owned *undivided* interests in an account containing securities. Each created inter vivos trusts for the life of the other, with absolute power in each beneficiary to withdraw $150,000 before a certain date. Harold died without having exercised this power and the amount as to which it could have been exercised was included in his taxable estate.

It is significant in the *Lehman* case that each grantor vested in the beneficiary, his brother, the *absolute* and *exclusive* right to invade the corpora of the trusts for his own benefit to the extent of $150,000, without consultation with or consent of the other, or the trustees or any person whatsoever. The two transfers occurred under such circumstances that, when completed, each of the transferors was in no different position with respect to $150,000 than if he had taken $150,000 of his own money and put it where he could lay his hands on it whenever he wanted it. On these facts, no one can be surprised that the Board and Circuit Court of Appeals included $150,000 in the taxable estate of the decedent.

In *Commissioner* v. *Dravo* (C.C.A. 3), 119 F. (2d) 97, the Court affirming the Board comments on the *Lehman* case.

In the *Dravo* case two brothers and their wives executed reciprocal trusts, each brother for his wife, and each wife for her husband. There was a provision in each trust whereby the trustees could in their discretion advance portions of the principal of the wife's trust to her husband, and portions of the principal of the husband's trust to his wife. The Commissioner urged that the corpora of these trusts were taxable for estate tax to the estates of the two husbands under the authority of the *Lehman* case.

The Circuit Court of Appeals distinguished the *Lehman* case, and noted especially "that *there* the life beneficiary was given an unqualified power to invade the corpus of the trust created by his brother."

The Board of Tax Appeals, in 40 B.T.A. 309 had previously denied the contention of the Commissioner in the following language at page 322:

> "We do not think we have the same situation here as we had in the Lehman case. There the decedent gave his brother Allan the absolute and unconditional right to withdraw the $150,000 in exchange for similar rights of the decedent in the trust created by Allan. No such absolute and unconditional rights are present in the instant proceedings. Neither of the decedents here could withdraw any of the principal of his wife's trust at his pleasure, nor could either wife withdraw any of the principal of her husband's trust at her pleasure. Neither Francis nor Ralph ever received any part of the principal deposited under the deeds of their respective wives. Any payment of principal under article second, section 1, of any of the four trusts could be made only in discretion of the trustees, and if they abused this discretion they would render themselves liable to any remainderman whose interest would thereby be adversely affected. Cf. Higgins *v.* White, 93 Fed. (2d) 357. We hold that no part of the corpora of the four trusts is includable in the respective gross estates of the decedents by reason of the provision contained in article second, section 1, of all four trusts whereby the trustees could in their discretion advance portions of the principal of the wife's trust to her husband and vice versa."

To support his insistence that the case at Bar is factually similar to the *Lehman* case, petitioner's counsel (pp. 4, 12 of his brief) quotes a statement by the Board member in this case, which the petitioner calls a finding of fact. The quotation of itself is dictum and only indicates the necessity for an exhaustive examination of all of the facts and circumstances before reaching a conclusion on whether the trusts as established should be respected.* The necessity for such examination of the attendant circumstances has nowhere been expressed more forcefully than by the Circuit Court of Appeals in the *Dravo* case.

It has been stipulated and agreed that the respondent and his brothers were motivated to set up the trusts so that the corpora should be secured from the hazards of the business, *secured against the action of the brothers themselves and each other,* and secured for the protection of their wives and children. To accomplish this, they deliberately and irrevocably integrated into the situation a trusted third person, their friend and counsellor, without whose consent no one of the trusts could be revoked. It was his role and obligation to represent the wives and children, to provide that in the event of the death of one of the brothers his widow and children would not be subject to the influence of the *remaining two brothers alone,* because each brother had his own idea of policy, *and was not willing to subject his estate to different philosophies of investment of the surviving brothers alone.* (R. 42, 43 and 44). He would veto any action adversely affecting the interest of the wives and children.

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* The two cases cited by petitioner at pages 14 and 15 of his brief, *Chase National Bank* v. *United States,* 278 U. S. 327, and *Helvering* v. *LeGierse,* 312 U. S. 531, are excellent examples of the necessity for this approach.

There is, therefore, no unconditional and absolute right in the respondent in the instant proceeding to revoke, alter or amend the Trust Indenture at pleasure. To argue that there is, requires reconstruction of the premises in defiance of the intent of the parties and the language of the trust instrument, and substitution for these of a fiction compounded of implication, deduction, speculation and unsupported reasoning.

POINT II

The same hypotheses upon which petitioner grounds the substitution of Jack for Albert as grantor, lead to the ultimate conclusion that the respondent did not have such power over the income that it might be treated as his gift when paid to the beneficiary.

A

Admitting *arguendo* that Petitioner succeeds in his contention that Jack L. Warner is the real grantor, and successfully avoids the logical substitution of Albert for Jack as "revocator," even then Jack is not possessed of power or control which would enable him to invade the corpus or divert the income of the trust without the consent of persons having a substantial adverse interest.

To support his main argument, petitioner has deduced from the record a recital of facts necessary to his contention. Such assumptions demand reliance upon the existence of all of the trusts and a fictitious relationship between each and every one of the grantors, trustees and "revocators". It is necessary to meet his suggestions concerning adverse interest only if his major premise is true. We therefore decry his attempt to confine his discussion of adverse interest to an analysis of the single trust created by Albert.

Even though Petitioner prevails in his argument that Jack L. Warner must be *assumed* to be the grantor of the trust in question, to complete his case he must establish that neither Harry M. Warner nor Stanleigh P. Friedman has a substantial adverse interest. This he attempts to do at pages 29-32 of his brief. In the first place he restrictively characterizes Friedman as "taxpayer's counsel" and then indulges in the speculation that if Friedman would not follow the taxpayer's wishes and repudiate his fiduciary obligations to his *cestuis que trust,* "it would be difficult to find anyone whose interests would not be considered adverse. * * * There was thus no basis for claiming that Friedman would not be amenable to the taxpayer's wishes".

On page 32 of his brief, Petitioner admits that "the question is a practical one and cannot be decided in a legal vacuum". (Citing *Fulham* v. *Commissioner,* 110 F. (2d) 916 (C. C. A. 1st).) We accept this test. Although concededly a practical question the Petitioner proceeds to decide it without reference to the facts.*

First—as to Friedman: he ignores the fact that Friedman had the confidence of *all* members of the Warner family, including wives and children; he impeaches Friedman's loyalty and responsibility to Harry and Albert, and bases his case on the conjecture that Friedman as "taxpayer's counsel" is subservient to the will of Jack. On the facts this conclusion is inconceivable. Friedman is the only person occupying the position of both trustee and "revocator" in all of the trusts; he cannot be removed either as trustee or as "revocator", and the record is clear

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* *Reinecke* v. *Smith,* 289 U. S. 172, and *Morton* v. *Commissioner,* 109 F. (2d) 47, give no real help in the solution of the problems arising out of the facts in this case. These cases as well as *Commissioner* v. *Caspersen,* 119 F. (2d) 94, and other cases prosecuted by the Commissioner to prevent tax avoidance by use of trusts, have been decided on the facts of each case, as required by the Supreme Court of the United States in *Helvering* v. *Clifford,* 309 U. S. 331.

on the reason for this. He is completely integrated into the administration of the several trusts and his interest and legal duty is to see that each trust is properly administered.

A necessary correction to the footnote on page 32, of Petitioner's brief, viz., adding Friedman as one of the persons having the power to amend or revoke in addition to Harry M. Warner and Albert Warner,—serves to contradict the statement on page 29 of Petitioner's brief, that "there was no basis for claiming that Friedman would not be amenable to the taxpayer's wishes". The footnote concedes that the "taxpayer" (and therefore any other person having the power to revoke, including Friedman) could refuse to cooperate and in this way could exert a pressure on the other grantors. This is tantamount to admitting that Friedman, being one of the persons having power to revoke has a substantial adverse interest.

The Petitioner has next directed his fire upon the interest of Harry M. Warner under the Albert Warner trust. If Albert is the actual grantor, it is unnecessary to go into the question of adverse interest in Harry. Discussion of Harry's position is only required by acceptance of Jack as the substituted grantor for Albert. On that hypothesis, what is Harry's relation to Albert's trust?

It can no longer be said that the words "substantial adverse interest" are used in the restrictive sense indicated by numerous cases dealing with the general law of trusts. These words will be given the significance required (at least in Federal tax cases) by the real powers, privileges and obligations of the trustee or beneficiary involved. (See *Commissioner* v. *Chamberlain,* 121 F. (2d) 765.

In *Commissioner* v. *Betts,* 123 F. (2d) 534, the contention of the Commissioner was that a mother and wife of the grantor, who were beneficiaries of the trust and whose consent must be had to revoke the trust, were not persons having a "substantial adverse interest". The Circuit Court of Appeals disagreed with the Commissioner and used this language (p. 539):

> "In this situation, though the beneficiaries are closely related to the grantor, he has given them certain rights which he was not bound to give them, certain income which he was not bound to give them; and over this he has surrendered control. It may be that because of family affection they might consent to a revocation, but that fact does not of itself destroy their quality of adverse holding protected by the statute. What Congress had in mind evidently was such a person as has a vested right under a trust agreement to insist upon its performance and cannot be compelled to surrender the same."

Harry had the right under the trust agreement "to insist upon its performance and cannot be compelled to surrender the same". It is both unfair and inconsistent with the petitioner's hypotheses, to define Harry's rights and declare them not adverse, because they are fixed by the terms of Albert's trust alone.

Petitioner's counsel eventually comes to acceptance of the more enlightened view of "substantial adverse interest" as defined in the *Betts* case. In his footnote at the bottom of page 32, he says "the taxpayer could refuse to co-operate and in this way could exert a pressure on Albert Warner to prevent revocation of the trust for the benefit of Harry Warner". Accepting this at face value, each of the three brothers had substantial interests adverse to each other.

B

Since there was no power in the respondent to obtain or control the payments of income and since the trustees were under the duty to make such payments to the beneficiaries, said beneficiaries received such payments as taxable income and not as gifts.

The instant case, decided by the Board of Tax Appeals subsequent to the decision of the Supreme Court in the *Clifford* case, reaffirmed the principle adopted by the Board in *Commissioner* v. *Mead,* 41 B.T.A. 424.

That the case at bar is apposite to the circumstances existing in the *Mead* case, can best be demonstrated by the following language of the opinion in the *Mead* case at page 428:

> "The instrument creating the trust entitled the beneficiary to the net income of the property held in trust during her lifetime or until the donor exercised his power to change beneficiaries. She thus became the owner of an equitable interest in the corpus of the trust property, subject to being divested by the happening of a subsequent event, Cf. *Blair* v. *Commissioner,* 300 U. S. 5; *Brown* v. *Fletcher,* 235 U. S. 589; *Irwin* v. *Gavit,* 268 U. S. 161. By virtue of this interest in the corpus of the trust she was entitled to enforce the trust, to have a breach of trust enjoined, and to require the net income to be paid over to her by the trustee. The interest was present property, alienable like any other in the absence of a valid restraint upon alienation. *Blair* v. *Commissioner, supra.* Since the net income was currently distributable to her, it became her property within the meaning of the taxing statutes at the time of its receipt by the trustee. United States *v.* Arnold, 89 Fed. (2d) 246. The reserved power of the donor did not affect the quantum of her interest. It only made its duration contingent upon the exercise of the power by the decedent to change beneficiaries."

Both the *Mead* case and the case at bar must be distinguished from those cases in which the transfer under consideration was merely an assignment of future income as in the case of *Corliss* v. *Bowers,* 281 U. S. 376. In that case the donor was deemed to have had control of the income to give away in such parts, estates and terms, as he wished, to rescind, retract or revoke such assignments, in whole or in part, and to substitute other persons as beneficiaries, without limitation. In cases like the *Blair* case and the instant case, the donor had no right, power or control over the income. He did have the power to terminate the trust and revest the corpus in himself, but this is not the equivalent of control over the disposition of the income such as was passed upon in *Corliss* v. *Bowers.*

It must be obvious, as it was to the court in *Stuart* v. *Commissioner* (C. C. A. 7, December 19, 1941), that "the recapture of the corpora of the trusts by petitioner [respondent] would be by virtue of the future exercise of his influence over the other trustees, and not by virtue of any right which he reserved or failed to grant at the time of his declaration * * *".

In the *Blair* case and in the instant case and in *Harrison* v. *Schaffner,* 312 U. S. 579, the beneficiaries were vested with equitable estates and income which was paid to them flowed from their equitable interest in the corpus of the trust estate.

Distribution was in satisfaction of the obligation of the trustee, and not a gift of income to the beneficiary by the donor of the trust at the time of distribution. It was reported as income by the beneficiaries and they paid income tax thereon.

We disagree with the suggestion of Roswell Magill appearing in the note on page 21 of Petitioner's brief that the reasoning of the Board in the *Mead* case seems inadequate. In the *Mead* case, distinction is drawn, between

equitable estates vested in beneficiaries who receive the income because of their equitable interest in the corpus (cf. *Blair* v. *Commissioner*), and assignments of future income from trusts (cf. *Corliss* v. *Bowers*).

The integration of income tax and gift tax impositions was refused by the Board in *Buck* v. *Commissioner*, 41 B.T.A. 99,* and in the *Mead* case. When an opportunity came to compel such integration, the Supreme Court of the United States in *Harrison* v. *Schaffner*, declined to go so far as some of the text writers expected and did not modify in any respect the rule laid down in the *Blair* case. On the contrary, the Supreme Court established a positive distinction which must be respected in the examination of income tax cases arising under Section 22 (a), I.R.C. as compared with those controlled by other provisions of the taxing statutes. The court is careful to point out in *Harrison* v. *Schaffner* that the decisions in the *Clifford, Horst* and *Eubank* cases all turned on the fact that skillfully devised anticipatory arrangements made it possible for the grantor, in the circumstances of those cases, to exercise his power to control the income and to enjoy the benefits thereof.

Careful analysis of these cases establishes the propriety of the decision in the *Mead* case. The presence of circumstances which might justify income taxation of a grantor because he controls the income, or on the theory that his obligation is satisfied, or because he receives a "non-material satisfaction" (cf. *Whiteley* v. *Commissioner*, 120 F. (2d) 782), any one of which might be sufficient to support the imposition, will not command a further imposition upon the passage of the income to the trust beneficiary *in the absence of an effective statute on May 26, 1932*. There is no such legislation and this is an

* The Circuit Court of Appeals in *Commissioner* v. *Buck*, 120 F. (2d) 775, reversing the Board, applied the *Clifford* rule of Section 22 (a) I.R.C., distinguished the *Blair* case, but did not even refer to the Sanford and other gift tax cases.

answer to the rhetorical question propounded by the Petitioner at page 21 of his brief. Although the Supreme Court in *Burnett* v. *Guggenheim* says, in effect, that Congressional legislation is unnecessary to support a fact (of transfer) the Board of Tax Appeals and the Circuit Court of Appeals for the First Circuit in *Commissioner* v. *Prouty,* 115 F. (2d) 331, were well advised in their refusal to accept the suggestion of the Government that the repeal of Section 501 (c) *necessarily* allowed the law of its own motion to step in and impose a tax on a payment by a trustee to a beneficiary which flowed from the complete divestment of the corpus prior to passage of the gift tax law.

There is another very significant distinction between Section 22 (a) income tax cases controlled by the rule of the *Clifford* and related cases, and gift tax cases controlled by the rule of the *Mead* and *Warner* decisions of the Board. This has to do with the period of time during which the grantor seeks to divorce himself from control over the income. The *Clifford* case has been distinguished in numerous subsequent cases and the rule of the *Clifford* case has been narrowed not only by Circuit Courts but with the approval of the Supreme Court.*

The cases which have usually been held to fall outside of the *Clifford* rule are those in which the opportunity for the grantor to repossess or enjoy the benefit of the income was remote, either in time or because the contingencies upon which such income would be enjoyed were not likely to occur.

In no case has the grantor been taxed on the income where the power to repossess the income required the exercise of revocation as to corpus or termination of the trust upon such remote possibilities as those existing in this case.

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* *Helvering* v. *Achelis,* 112 F. (2d) 929 (C. C. A. 2d, 1940);
Commissioner v. *Branch,* 114 F. (2d) 985 (C. C. A. 1st, 1940);
Helvering v. *Palmer,* 115 F. (2d) 368 (C. C. A. 2d, 1940);
Commissioner v. *Chamberlain,* 121 F. (2d) 765 (C. C. A. 2nd, 1941);
Jones v. *Norris,* 122 F. (2d) 6 (C. C. A. 10th, 1941);
Commissioner v. *Jonas,* 122 F. (2d) 169 (C. C. A. 2nd, 1941)

Distinction must again be drawn between the application of the rule laid down in cases referring to corpus, and the extension of the rule to cover possible application thereof to annual accruals of income in the hands of the trustees for the account of the beneficiaries. The distinction is emphasized by the reasoning of the Board in the *Prouty* case, 41 B.T.A. 274, 278, where it was stated "If there had been a similar taxing statute during all of those prior years, these trusts would not have escaped tax in some prior year".

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The Stipulation definitely establishes that Albert completed the transfer of his property in trust prior to the effective date of the Gift Tax Title of the Revenue Act of 1932. The transaction was, both in form and in fact, so complete and absolute that no gift tax may be claimed upon the payment of any income arising from said trust.

If the trust here in question had been created on July 1, 1932, subsequent to the enactment of the Revenue Act of 1932, a gift tax would have been imposed upon the transfer of the corpus of the trust and no one could thereafter have suggested that the income flowing therefrom would be subject to gift tax.

Completed gift of corpus carries with it gift of future income. Can it be said that in the case of a completed gift of the corpus *prior* to June 6, 1932, the payments of subsequently accruing income would be subject to gift tax?

The case of *In re Hoyt's Estate*, 149 N. Y. Supp. 91 (Surrogate's Ct. N. Y. County, 1914), appearing in the footnote of page 23 of Petitioner's brief, has been in effect overruled by the Court of Appeals of New York in the important case of *Matter of Schmidlapp,* 236 N. Y.

278 (1923). In this case Judge Cardozo writing for the Court says at page 284:

> "The distinction is between a gift which clothes the donee with a right of present enjoyment, though subject to revocation at the will of the donor, and one where the donor reserves to himself not only the power to revoke, but also enjoyment during life, so that no beneficial right enforcible against him exists until his death. In the one class of cases, the law in force at the delivery of the deed, and in the other the law in force at death, is the measure of the right to tax."

Applying this principle here, our case is clear. When the trust of Albert Warner was created on May 26th, 1932, no right of present enjoyment in the income was reserved by the grantor. The beneficiaries were entitled to receive the income from the trustees. In this situation the law in force at May 26, 1932, is the controlling law and it cannot be suggested that the law in force at the time when the income was paid, may be invoked to support a claim that the gift was not complete on May 26, 1932.

The Petitioner would have it appear that when the Trust was created on May 26, 1932, there was some reservation of power which would support the imposition of a gift tax when subsequently accruing income was paid to the beneficiaries.

Prior to enactment of the Gift Tax Act of 1924, Guggenheim created a trust in which he reserved a power of revocation. Thereafter, and subsequent to passage of the Act, he annulled the power of revocation. The Commissioner claimed that annulment of the power of revocation completed what had previously been an inchoate gift, and the Supreme Court supported the Com-

missioner in this contention. (*Burnet* v. *Guggenheim,* 288 U. S. 280.)

Referring to Section 501 (c) of the Revenue Act of 1932 repealed by Section 511 of the Revenue Act of 1934, Mr. Justice Cardozo, speaking for the court, said that Section 501 (c) had been merely "declaratory of the law [Gift Tax] which Congress meant to establish in 1924". The incorporation of Article 1, Regulations 67 (1924), into the statutory language of the Revenue Act of 1932, the Court said "will give the rule for *later* transfers." (Italics ours.)

The rule laid down in *Burnet* v. *Guggenheim,* was of no effect between January 1, 1926, the effective date of repeal of the Revenue Act of 1924 and June 6, 1932, the effective date of the Revenue Act of 1932.

Subsequently enacted statutes and interpretations thereof cannot be invoked retroactively to support a tax in the instant case upon a transfer which was in all respects completed before the incidence of the taxing act. (*Schwab* v. *Doyle,* 258 U. S. 529; *Hasset* v. *Welch,* 303 U. S. 303.)

Retroactivity of statutes and regulations has been permitted and approved by the courts in connection with income taxes. Income tax is an excise on the privilege of receiving and enjoying income computed on an *annual* basis. Estate tax, and gift tax which is deemed to be in *pari materia,* has not been imposed upon a transfer antedating the incidence of the taxing statute. Regulations 79, issued under the Revenue Act of 1932, gave approval to the principle that a completed transfer of corpus carried with it a completed gift of income thereafter flowing from such corpus. The regulations so worded were contained in Article 3, which was printed in the appendix attached to Petitioner's brief herein. These regulations were revised in 1936 and Petitioner, realizing that the language

of the revised regulation lays a better foundation for the test that he would now apply, has sought to obtain the privilege of filing a new appendix to his brief containing Article 3 as revised in 1936, which he asks be substituted for that originally "filed in error". Comparison of the regulations of 1932 with those of 1936 serves to emphasize a change in thinking by the Commissioner, which now leads him to invoke a new rule of interpretation in *income tax* cases to support his attempted retroactive application of the gift tax statute. It was only after Sections 166 and 167 as amended by the Revenue Act of 1932 were introduced into the basic income tax law, that the Government sought and the courts gave approval to an enlarged application of Section 22 (a) I.R.C. (Section 213 (a) Revenue Acts of 1924 and 1926). Re-enactment of Section 22 (a) in substantially the same form as Section 213 (a) of the prior acts, accompanied by amendment of Sections 166 and 167 in the Revenue Act of 1932, might justify the courts in assuming Congressional intention to tax income of trusts as the income of the grantor where the grantor had always dominated and controlled the income, but this principle of construction should not be invoked to justify imposition of gift tax on income passing under a trust established prior to the Revenue Act of 1932.

If the established rule of law be applied to the facts, we have a completed transaction and no problem of taxation. To avoid this consequence, the Commissioner substitutes Jack for Albert as grantor and creates a factual fiction to justify the imposition of a different rule of law garnered from *subsequent* statutes and their interpretation. Thereby, the Commissioner arrogates to himself authority which the courts have denied even to Congress. "There are, however, limits to the power of Congress to create a fictitious status under the guise of

supposed necessity". *Helvering* v. *City Bank Farmers Loan & Trust Co.,* 296 U. S. 85.

As a matter of fact, the payments of income to the beneficiaries which "were treated for Federal income tax purposes as the taxable income of said beneficiaries" (R. 36) were paid over to the beneficiaries by the trustees pursuant to their legal obligation so to do.

In *Blair* v. *Commissioner,* 300 U. S. 5, at page 13, the Supreme Court said:

> "By virtue of that interest he was entitled to enforce the trust, to have a breach of trust enjoined and to obtain redress in case of breach. The interest was present property alienable like any other, in the absence of a valid restraint upon alienation. Commissioner of Internal Revenue *v.* Field (C.C.A. 2nd), 42 F. (2d) 820, 822; Shanley *v.* Bowers (C.C.A. 2d), 81 F. (2d) 13, 15.
>
> * * * * * * *
>
> The assignment of the beneficial interest is not the assignment of a chose in action but of the 'right, title and estate in and to property' ".

Conclusion.

The petitioner here is appealing for equitable reformation of a factual situation.

> "A court of equity has power to control the administration of a trust so that it will accord with the purposes of the grantor. A discretion lodged in a trustee is rarely, if ever, to be regarded as a permit to act arbitrarily. Such discretion should be confined to the exercise of judgment not unreasonable in the light of the purposes of the trust and of the circumstances in which it is sought to be exercised. The power of the court exists solely for the protec-

tion of the right of the grantor and the beneficiaries."

Stuart v. *Commissioner,* C. C. A. 7, December 19, 1941. (Affirming in part and reversing in part 42 B. T. A. 1421.) (See also Restatement of Law of Trusts, Sec. 170.)

Congress did not intend and the courts have not implied a Congressional purpose to alter declared trust objectives, unless it be clearly shown that the grantors had in substance retained the trust *res* or continued to hold powers over the income which would make the income subject to the beneficial use of the grantor. After all this is a simple factual case. Nothing in this record would justify this court in applying abnormal rules to the trust here involved and changing the tax consequences attaching thereto. The Board of Tax Appeals has so found and should be affirmed.

January, 1942.

Respectfully submitted,

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